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SUBJECT: PENSION REFORM: NERO'S ORCHESTRA PRACTICING FOR UPCOMING PERFORMANCE

REF: ROME 1899

SUMMARY

¶1. Like many of its European partners, the Berlusconi government is struggling to reform Italy's generous pension system and control anticipated runaway growth in pension expenditures in the coming years. At this stage, it's not at all clear the government will succeed. There's widespread agreement that the current system, if not yet broken, will break down shortly. But every self-styled mechanic has a different solution, one that reflects, naturally, its own priorities. The competing interests, both across society and within the Berlusconi government's coalition, have marched steadily toward confrontation. The unknown variable, at this point, is Berlusconi, who has espoused a variety of views on both the content and timing of concluding a reform package wending its way through parliament. His real position on the issue, one that truncated his first stint as prime minister, will determine whether the current reform package comes to fruition or goes up in smoke. END SUMMARY.

FROM ECONOMIC MILLSTONE...

¶2. Italy's pension system suffers from the same structural problems plaguing those in many other advanced industrial European economies: an overly generous defined-benefit scheme that is not sustainable with the country's aging population. Too few workers are paying for too many retirees; those pensioners are living longer than ever and, consequently, taking far more out of the pension system than they ever put into it. The current system, which allows many Italians to retire as early as age 57 on as much as 75 percent of their high salary range, sucks up 13.9 percent of GDP (second only to Austria). Absent substantial reforms that delay eligibility, reduce benefits or both, the pension millstone will grow to 16 percent of GDP in 2033. It's no wonder the subject is enough to send most politicos and government budget officials running for the hills.

¶3. In 1995, then-Prime Minister Dini completed the first substantial reforms to the system, launching a gradual shift from a defined-benefit to defined-contribution scheme, raising the retirement age for many to 65 and creating a "second pillar" in the pension system, private pension funds. These important structural changes yielded over 28 billion euros in savings from 1996-2000, saving the public system from insolvency. But the real pain necessary for long-term sustainability -- reduced pensions (and the attendant popular outcry) -- was deferred until 2005, when the formulae/coefficients used to calculate annuities may first be "reevaluated" (i.e., lowered). Moreover, Italy's undercapitalized securities markets, dominated by a small coterie of companies, have generated neither the returns nor the stability and confidence required to attract workers' retirement savings. Less than ten percent of eligible workers have money invested in the 44 collective private pension funds established through labor-management negotiations.

...TO ELECTORAL CORNERSTONE

¶4. Prime Minister Berlusconi made pension reform a cornerstone of his 2001 electoral "contract with Italy" to revitalize the economy, improve government services and, in general, make Italy more competitive. Two years later, the government has shown little progress on this piece of the economic reform puzzle. Despite a substantial parliamentary majority, reform legislation languished in committee until late February, when a modest package cleared the lower Chamber of Deputies. That slow pace reflected both the explosive nature of the issue and the lack of consensus, either within the government or between the government, employers and unions -- over the best package of reform measures. Italy's three major union confederations agree on little else these days, but they have forged a common position on pension reform. Labor ministry officials have told us that it also reflected a tactical decision to await

help from Brussels, in the form of EU recommendations on further reducing Italy's public debt and revamping the pension system, that it could use in developing a consensus.

INTERIM SOLUTION DRAWS MIXED REVIEWS

¶5. In the meantime, the government is pursuing a two-pronged interim solution: energizing private pension funds by injecting additional capital, and improving incentives for employees to defer retirement and reducing their pension contributions. Though many judged the reform proposal that passed the Chamber in late February surprisingly modest, its provisions bundled measures to accomplish these objectives with sweeteners to secure the acceptance of employers, who are most concerned with excessively high overall labor costs. The legislation:

-- abolishes mandatory retirement at 65;

-- creates additional incentives for employees to continue working past 65, primarily by reducing their payroll tax rate for social security (and thereby raising their take-home wages) and maintaining provisions of the standard labor contract as well;

-- provides employers additional incentives to hire new workers, lowering employers' contribution to public pension funds for new young workers by up to 5 percent;

-- requires employers to transfer severance pay (which they currently hold in escrow pending employee's departure) to private pension funds.

Implied but unspoken in the legislation is the government's intended second step: an actual reduction of public pensions, perhaps either via adjustment of the annuity coefficients during the 2005 review required under the Dini reform package or pro-rata extension of the defined-contribution scheme to all workers. Some analysts believe the Berlusconi government thinks it will be able to weather public opposition to reduced benefits under the new defined-benefit scheme if it has succeeded in creating an alternative private system to provide additional retirement income to offset the loss of public pension money.

¶6. Not surprisingly, both employers and unions found plenty objectionable in the draft legislation. Employers are unenthused by the prospect of relinquishing management of the severance pay, which has provided a handy working capital fund for many companies (since they must set aside severance for all employees but only pay out a small portion to those employees who depart in a given year). Confindustria, the largest employers' association, was unhappy with the proposal but ultimately accepted it because it was accompanied by reductions in employers' overall labor costs. But the organization continues to call for more radical reform, including use of disincentives (reduced annuities) to discourage workers from retiring early.

LABOR'S SUPPORT FOR DIFFERENT PLAN

¶7. Labor, meanwhile, has a radically different set of priorities and proposed solutions. The unions agree that excessively high labor costs are stifling business growth and, to varying degrees, support long-term structural changes to the public pension system. But with roughly half their collective membership drawn from the ranks of retired workers, the unions strongly oppose any short-term reductions in pensions -- or any structural changes that might make future reductions (say, when the annuity coefficients are reevaluated in 2005) easier. After months of independent action, the three confederations hammered out a joint position in March that:

-- opposes a mandatory shift of severance pay; instead, workers would retain the choice but be encouraged to shift their severance to the private funds through tax breaks;

-- proposes additional incentives to funnel severance pay into "closed" pension funds, established on a sectoral or company basis and managed jointly by employers and unions;

-- opposes reductions in employer contributions to public pensions;

-- suggests reducing employers' labor costs by reducing contributions to other social programs, such as maternity leave, instead of to the pension system.

POSSIBLE JUNE CONFRONTATION

¶8. For all of the maneuvering, there is still no clear impetus, or reason, for early resolution. Berlusconi has blown hot and cold, spending much of the spring underscoring the imperative of rapid agreement of the package, then announcing May 22 that pension reform was a "European problem" whose repair should await Italy's EU presidency tenure. The main force for early agreement appears to be Labor Minister Maroni (one of three ministers from the idiosyncratic, regionally-focused Northern League), who spent much of the last month in serial sessions with both employers and unions. Maroni had sought to reassure labor and coax some flexibility from it by suggesting that one possible fix -- disincentives for early retirement, in the form of reduced annuities -- was off the table. In early May, though, PM Berlusconi showed one of his cards in declaring his support for disincentives, comments that were echoed by Deputy Prime Minister Fini (head of the second largest coalition partner, National Alliance) and Confindustria head D'Amato. D'Amato is the other force driving for early resolution, urging the government to conclude the reform package before parliament is embroiled in its annual budget battles.

¶9. In response, Maroni sought, and secured, Berlusconi's agreement to a cabinet meeting to reaffirm a unified government position on the draft legislation -- and reiterated his position that the final package would not include disincentives. In the run-up to the cabinet meeting, the unions are holding firm to their position, promising coordinated general strikes in late June if the legislation is not modified to reflect their position.

WHICH LEAVES US...HANGING

¶10. Whichever metaphor one prefers, it's not at all clear how this will play out. Despite near-universal agreement that the pension system needs fixing, the substantial differences among the various self-styled mechanics makes a compromise difficult. Maroni continues to insist that a workable compromise is achievable, but one wonders if he's trying to convince himself as much as the wider audience. How the battle over the reform legislation plays out will go a long way to determining how much stomach the government has to tackle the heart of meaningful pension reform -- reduced public annuities-- that looms toward the end of its expected term in office.
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